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STATE PASS TO OPIC FOR CCOUGHLIN

E.O. 12958: N/A
TAGS: EINV OPIC KTDB USTR BR
SUBJECT: BRAZIL INVESTMENT CLIMATE 2006

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¶1. This cable transmits Mission Brazil's submission of the 2006 Investment Climate Statement. This document has already been forwarded to USDOC by e-mail.

Openness to Foreign Investment
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¶2. Brazil is open to and encourages foreign investment. The Brazilian Congress approved constitutional amendments in 1995 to eliminate the distinction between foreign and national capital. Foreign investors have been permitted to invest in the Brazilian stock market since 1991; new rules, which liberalized considerably foreign investment in equities and put foreign investors essentially on an equal footing with Brazilians, took effect in 2000. The 1962 Foreign Capital law and subsequent amendments govern most foreign investment. During the high point of the privatization program, Brazil was the second largest destination for foreign investment among emerging markets, with a peak inflow of $32.8 billion in 2000; the country remains a leading investment destination.

¶3. Constitutional amendments passed in 1995 opened formerly closed sectors, such as petroleum, telecommunications, mining, power generation, and internal transport to foreign investors. In 2002, Congress approved a constitutional amendment permitting foreign investors to own up to 30% of media companies. Restrictions remain on foreign investment in a limited number of sectors: nuclear energy, health services, media, rural property, fishing, mail and telegraph, aviation and aerospace. Law 10,610 (2002) limits foreign ownership in media outlets to 30 percent, including the print and "open broadcast" (non-cable) television sectors. Brazil's legislature is considering extension of this restriction to cover Internet Service Providers, pay TV channels and operators, and content producers and distributors; such a change would pose a serious threat to a number of U.S. companies operating in Brazil as content producers/distributors.

¶4. New or expanded foreign investment in the banking sector is technically forbidden by the Constitution of 1988. However, since 1995 entry or expansion has been approved on a case-by-case basis; the vast majority of requests for entry or expansion have been granted. Foreign banks currently account for 27% of the net worth of the banking system and 23.4% of total banking system assets.

Since 1996, the insurance sector has been open to foreign investors, and most major US firms are already represented, mainly via joint venture arrangements. Brazil maintains a government-owned reinsurance monopoly, the Brazil Reinsurance Institute (IRB). The Lula administration has not pursued privatization of the IRB but it has proposed legislation, sent to Congress in May 2005, which would dismantle the IRB's monopoly and permit new entrants in the reinsurance sector. The Congress has not acted on the bill.

¶5. In 1991, Brazil embarked on the world's largest privatization drive, selling off more than US$ 100 billion worth of assets. Since 2002, however, privatization has virtually stopped. Through 2005, Brazil realized $87.8 billion in sales revenue and another $18.1 billion in debt transfer as a result of the national privatization program. Foreign investment accounted for $42 billion, or 48% of the total. One third of the foreign investment was from the US ($14 billion). With the exception of power-generation sector, in which the majority of power generation capacity remains in government hands, most of the largest state enterprises have been sold in whole or in part. Privatization activity has slowed substantially since 2001; in 2002, it totaled only US$ 2 billion; in 2003 there were no privatizations. The Lula administration has carried out two privatizations, the 2004 sale of the State Bank of Maranhao for US$ 26.6 million and the December 2005 privatization of the State Bank of Ceara for US$ 302 million. In December 2004, the Congress approved and the President signed a Public-Private Partnership (PPP) investment law that promotes joint ventures in otherwise marginally profitable infrastructure investments; the first such projects may be bid in 2006. The law creates a federal guarantee fund to protect investors in federal PPPs.

¶6. In December 2004 and April 2005, Brazil conducted its first auctions of long term energy supply contracts under a new energy



regulatory framework advanced by the Lula administration. Under the new model the federal government now plays a more central role in establishing energy demand forecasts and energy prices. Although a central goal of the new model is to attract private investment in power generation, several investors that bought energy assets during the now-halted energy sector privatization were disadvantaged by the transition to the new regulatory system. Analysts, companies and investors also have expressed concern that the more centralized government role and low auction prices will inhibit private investments. A majority of power generation capacity remains in public hands.

¶7. During the early 1990s, foreign direct investment (FDI) was a crucial source of financing for Brazil's balance of payments. Dramatic growth in Brazil's exports has produced trade surpluses since 2001 and current account surpluses since 2003 have dramatically reduced the importance of FDI as a source of external financing. Moreover, the winding down of the privatization program has seen FDI fall from a 2000 peak of $30 billion to a low of $10.1 billion in 2003. FDI inflows have since picked up, increasing to $18.2 billion in 2004 and an estimated $15 billion in 2005.

¶8. Brazil has undertaken a significant reduction in trade barriers in recent years. In 2005, Brazil's average Normal Trade Relations (NTR) tariff was 10.7%, versus 32% percent in 1990, according to the Foreign Trade Secretariat of the Ministry of Development, Industry and Foreign Trade.

¶9. Foreign investors may own real estate, but purchase of land along the borders by foreigners requires specific authorization.

## Conversion and Transfer Policies

¶10. There are few restrictions on converting or transferring funds associated with an investment. Foreign investors may freely convert Brazilian currency in the unified foreign exchange market wherein buy-sell rates are determined by market forces. All foreign exchange transactions, including identifying data, must be reported to the Central Bank. Foreign-exchange transactions on the current account have been fully liberalized in practice.

¶11. Foreigners investing in Brazil must register their investment with the Central Bank within 30 days of the inflow of resources to Brazil. Registration is done electronically. Investments involving royalties and technology transfer must be registered with the patent office (INPI) as well. Investors must have a representative in Brazil and register with the Brazilian securities commission (CVM). Subsequent transactions, such as reinvestment of profits, may also have to be registered with the Central Bank.

¶12. Foreign investors, upon registering their investment with the Central Bank, are able to remit dividends, capital (including capital gains), and, if applicable, royalties. Remittances must also be registered with the Central Bank. Dividends cannot exceed corporate profits. The remittance transaction may be carried out at any bank by documenting the source of the transaction (evidence of profit or sale of assets) and showing that applicable taxes have been paid.

¶13. Foreign loans obtained abroad no longer require advance approval by the Central Bank, provided the recipient is not a government entity (loans to government entities still require prior approval). Upon concluding the transaction, the loan must be registered electronically with the Central Bank. In most instances, the registration is completed automatically. Automatic registration is not issued when the costs of the operation are "not compatible with normal market conditions and practices." In such instances, the loan is reviewed by the Central Bank; if the Central Bank does not respond within five working days, the registration is considered complete.

¶14. Interest and amortization payments specified in the loan contract can be made without additional approval from the Central Bank. That also applies to early payments, if there is a provision in the contract for early payment. If the contract does not have such a provision, early payment requires prior approval by the



Central Bank. According to Central Bank officials, this requirement is to ensure accurate records of Brazil's stock of debt, and all requests have been approved since the new guidelines were issued in ¶2000.

¶15. In addition to payments associated with registered loans and investments, there are other approved procedures for transferring funds abroad that in practice can be used for a wide range of purposes.

¶16. Capital-gain remittances are subject to a 15 percent income withholding tax. Repatriation of an initial investment is exempt from income tax. Beginning in 2000, lease payments were assessed a 15 percent withholding tax. Remittances related to technology transfers are not subject to the tax on credit, foreign exchange, and insurance (IOF), although they are subject to a 15% withholding tax and an extra 10% Contribution of Intervention in the Economic Domain (CIDE). Loans with terms of 90 days or less must pay the IOF (5%), while those of longer maturity do not. In 2002, Brazil eliminated the application of the financial transaction tax (CPMF), which is currently 0.38%, to stock market transactions. Foreign cable and satellite television programmers are subject to an 11 percent remittance tax; however, the tax can be avoided if the programmer invests 3 percent of its remittances in co-production of Brazilian audio-visual services.

¶17. Brazil has no double taxation treaty with the US, but does have such treaties with a number of other countries, including, among others, Japan, France, Italy, the Netherlands, Canada and Argentina.

## Expropriation and Compensation

¶18. There have been no expropriatory actions in Brazil in the recent past nor any signs that the current Government is contemplating such actions. In 1999, a state government sought and obtained a court ruling canceling contractual obligations, signed by the prior state

government, associated with the partial privatization of a state electricity company. The U.S. investors are appealing the court ruling. In 2003, a newly inaugurated government in another state refused to honor a number of contracts the previous state government had signed with a range of Brazilian and foreign investors; the parties involved continue to negotiate these contract disputes and have had recourse to local courts. Some claims regarding land expropriations by state agencies many years ago have been judged by courts in US citizens' favor. There remain individuals who have not yet been compensated because the states have appealed these decisions.

Dispute Settlement
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¶19. Brazil is not a member of the International Center for the Settlement of Investment Disputes (ICSID - also known as the Washington Convention), but it is a party to the New York Convention of 1958 on the recognition and enforcement of foreign arbitration awards. In August 1995, Brazil ratified the 1975 Interamerican Convention on International Commercial Arbitration, as well as the 1979 Interamerican Convention on Extraterritorial Validity of Foreign Judgments and Arbitral Awards.

¶20. Arbitration clauses in contracts are not automatically enforceable. Foreign arbitral awards require confirmation by a court of the country in which the award was rendered and by the Brazilian Supreme Court. This confirmation is procedural in nature, and not meant to consider the merits of the case. Confirmation by the Supreme Court allows the claimant to enforce the arbitral award through Brazilian courts. The Supreme Court has confirmed foreign arbitral awards between two private parties in multiple cases. Some companies opt for domestic arbitration as an alternative.

¶21. There is some legal controversy in Brazil over binding foreign arbitration between foreign investors and state entities. Some Brazilian legal interpretations claim this is prohibited under Brazilian law on the grounds that it infringes the sovereign rights of the state. The Federal Government nevertheless maintains, in the



absence of a definitive judicial ruling on the issue, that it can agree to binding foreign arbitration and routinely enters into contracts that allow for such arbitration.

¶22. This legal uncertainty, as well as congressional politics, has held up ratification of Bilateral Investment Agreements that Brazil has signed with fourteen countries (not including the US), which call for arbitration by either ICSID or a panel set up under the United Nations Rules for International Commercial Law. Given the doubts about the applicability under Brazilian law of these international arbitration provisions to Brazilian government entities, the government in December 2003 withdrew the agreements from consideration for Senate ratification.

¶23. Brazil has a functional commercial code that governs most aspects of commercial association, except for corporations formed for the provision of professional services, which are governed by the civil code. In December 2004, Congress approved an overhaul of the bankruptcy code. The reforms create a system, modeled on Chapter 11 of the U.S. bankruptcy code, which allows a company in financial straits to negotiate a restructuring with its creditors outside of the courts. In the event a company does fail despite restructuring efforts, the reforms give creditors a better chance at recovering their debts. An overburdened court system is available for enforcing property rights but decisions can take years. Judicial reform measures enacted in December 2004 streamline administrative procedures, and, by introducing the concept of binding precedent, should, over time, make judicial decisions more predictable.

Political Violence (As it May Affect Investments)
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¶24. Brazil's major urban centers suffer from significant drug trafficking-related and organized crime-related violence. Poverty,

gangs, drugs and a lack of government resources have combined to erode state authority in some urban slums (favelas). There have been episodes of drug-related violence prompting major police crackdowns, particularly in Rio de Janeiro. Police have been implicated in significant human rights violations, including extra-judicial killings, abuse of prisoners, and other criminal activity. Since mid-2003 the Landless Workers' Movement (MST) has continued its aggressive invasions of a variety of agricultural interests, both domestic and foreign, in its campaign to force redistribution of land. In rural areas, powerful landowners, sometimes aided by police or private security agents, have used violence to settle land disputes, including but not limited to those with the MST or indigenous peoples, and to influence the local judiciary.

## Corruption

¶25. Corruption can be an obstacle to investment in Brazil. In general terms, businesses find corruption an obstacle in government procurement and at some levels of the judiciary. 2005 saw a range of corrupt activities of spectacular scope come to light as Brazilian Congressional and law enforcement authorities began multiple investigations into illicit financing by several political parties of their 2002 presidential campaigns. The campaign financing investigations uncovered a multi-layered corruption scandal involving alleged vote-buying in the Congress by elements within the President's PT party and executive branch, financed by kickbacks on government procurement contracts and influence peddling. Brazil is a signatory to the Organization for Economic Cooperation and Development (OECD) Anti-Bribery Convention. While Federal government authorities generally investigate allegations of corruption, there are inconsistencies in the level of enforcement among individual states.

## Performance Requirements and Incentives

¶26. Geographic preferences consist of tax benefits for investment in less developed parts of the country, such as the Northeast and the Amazon, with equal application to foreign and domestic investors. These benefits have succeeded in attracting some major foreign



plants to, for example, the Manaus Free Trade Zone, but most foreign investment remains concentrated in the more industrialized southern part of Brazil. Individual states have sought to attract investment by offering ad hoc tax benefits and infrastructure support to specific companies, negotiated on a case by case basis. Some municipalities provide land on favorable terms for industrial development.

¶27. In firms employing three or more persons, Brazilian nationals must constitute at least two-thirds of all employees and receive at least two-thirds of total payroll. Foreign specialists in fields where Brazilians are unavailable are not counted in calculating the one-third permitted for non-Brazilians.

¶28. On November 21, 2005, Brazil's President signed law 11,196 which provides tax benefits to qualifying exporters. The law's Special Regime for the Information Technology Exportation Platform (REPES) suspends PIS/PASEP and COFINS taxes on goods and services imported by companies which commit to export software and IT services to the extent that those exports account for over 80 percent of annual gross income. The MP's Special Regime for the Acquisition of Capital Goods by Exporting Enterprises (RECAP) suspends these same taxes on new machines, instruments and equipment imported by companies which commit for a period of at least three years to exports goods and services such that they account for at least 80 percent of overall gross income. The government also has a series of smaller programs designed to assist small and medium sized businesses to export.

¶29. The Special Agency for Industrial Financing (FINAME) of the National Bank for Economic and Social Development (BNDES) provides financing for purchases by Brazilian firms of Brazilian-made

machinery and equipment -- capital goods with a high level of domestic content.

Right to Private Ownership and Establishment
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¶30. Foreign and domestic private entities may establish, own, and dispose of business enterprises.

Protection of Intellectual Property Rights (IPR)
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¶31. Brazil is a signatory to the GATT Uruguay Round Accords, including the Trade Related Aspects of Intellectual Property (TRIPS) Agreement, signed in April 1994. Brazil is a member of the World Intellectual Property Organization (WIPO) and a signatory of the Bern Convention on artistic property, the Washington Patent Cooperation Treaty, and the Paris Convention on Protection of Intellectual Property. In August 1992, Brazil removed its reservations and fully accepted the Stockholm revision of the Paris Convention. Brazil has not yet ratified the WIPO Treaties on Copyright and Performances and Phonograms. As a result of problems regarding protection of intellectual property rights, principally in enforcement, Brazil was retained on the Special 301 priority watch list in the 2005 review.

¶32. Patents. In most respects, Brazil's 1996 Industrial Property law brings its patent and trademark regime up to the international standards specified in the TRIPS Agreement. However, the law includes local working requirements which may be TRIPS-inconsistent. The law would theoretically permit the grant of a compulsory license if a patent owner has failed to "work" (i.e. locally manufacture) the patented invention in Brazil within three years of issuance. Invoking TRIPS provisions, Brazil has at times threatened to issue compulsory licenses for anti-retroviral drugs used in treating HIV/AIDS if satisfactory supply agreements, including a reduction in prices, could not be reached with patent-holders; to date Brazil has not issued such a license. Negotiations were successfully completed with one U.S. pharmaceutical company in 2005 and are on on-going with two others.

¶33. Trademarks. The fraudulent use of internationally "famous" marks has been a problem in Brazil. However, the Industrial Property Law has provided improvements in Brazil's trademark regime, including better protection for internationally known trademarks.



Some foreign firms have been successful in court actions against trademark infringement. Trademark licensing agreements must be registered with the National Institute of Industrial Property (INPI) to be enforceable; however, the failure to register licensing agreements will no longer result in cancellation of trademark registration for non-use.

¶34. Copyrights. Brazil's copyright law generally conforms to world-class standards. Likewise, its software copyright protection law contains provisions that introduce a rental right and an increase in the term of protection to 50 years. Despite passage of these copyright laws in 1998, widespread piracy of copyright and trademark material remains a problem. The US private sector estimates that trade losses from copyright infringements (including from piracy of videocassettes sound recordings and musical compositions, books and computer software) were $960 million in
¶2004. Nonetheless, given progress on enforcement in 2005, the U.S. Government in January 2006 announced that it would maintain Brazil's trade benefits under the Generalized System of Preferences after a review prompted by a 2000 petition from the International Intellectual Property Rights Association.

¶35. The Brazilian Congress passed a law in July 2003 that increased minimum prison sentences for copyright violations and established procedures for making arrests and destroying confiscated products. However, the heftier sentences have not acted as effective deterrents due to the continued ability of judges to commute many of the prison terms to fines. A much-publicized Special Congressional Inquiry into IPR piracy completed its report in June 2004, amidst

considerable sensation after a reputed piracy kingpin was arrested on charges of trying to bribe the chairman of the inquiry commission. In November 2004, the government created a high-level, inter-ministerial, National Council to Combat Piracy and Intellectual Property Crimes. In 2005, the Council developed and has begun implementing a national plan for combating piracy and smuggling.

¶36. Integrated Circuit Layout Designs. A government-drafted bill to provide protection for the layout design of integrated circuits (computer mask works) was introduced in the Brazilian Congress in April 1996. In 2004 the administration asked that the Congress give the bill greater priority as part of a package of measures to stimulate innovation and local production of electronics. The draft law has made it through several Congressional committees but was still under discussion in 2005.

Regulatory System (as it pertains to investments)
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¶37. Although some improvements have been made, the Brazilian legal and procedural system is complex and overburdened. State courts in particular can be subject to political influence. The central government has historically exercised considerable control over private business through extensive and frequently changing regulations. The bureaucracy has broad discretionary authority.

¶38. Taxes are numerous and burdensome, but do not discriminate between foreign and domestic firms, although in a few instances there have been complaints that the value-added tax collected by individual states (ICMS) is set to favor local companies. Taxes on commercial and financial transactions are particularly burdensome, and businesses complain that these taxes hinder international competitiveness of Brazilian products. Brazil has separate value-added tax systems run by the federal government and individual state governments. The administration has made some recent efforts at tax reform, including the conversion of invoice taxes to VATs at the federal level in 2003 and 2004. A 2004 measure reduces taxes paid on long term investments. A measure to simplify and harmonize the state-level VATs (which vary from state to state and product by product) was proposed but did not pass in 2003.

¶39. Regulatory agencies for sectors such as telecommunications, energy and transportation are a relatively young phenomenon in Brazil. ANATEL, the country's telecommunication agency, handles licensing and assigns bandwidth. The National Petroleum Agency (ANP) has been commended by the industry for its fair handling of auctions of oil exploration blocks and its willingness to assist



industry in seeking to simplify regulatory procedures such as environmental licensing. Conversely, in the electric power sector, some companies have complained about the high level of regulatory risk, for example the tariff review process and the implementation of the Brazil's new energy model. The federal government in 2003 passed legislation setting fixed three-year terms for directors of the regulatory agencies. Congress passed legislation in 2005 to create a civilian air transport industry regulator (ANAC). The new agency, expected to begin functioning in 2006, will exercise regulatory functions previously the responsibility of a directorate overseen by the Brazilian Air Force. Separate legislation to further clarify the roles and responsibilities of the regulatory agencies and consolidate the multiple laws currently governing each separate regulator was still under consideration by the Congress at end-2005. Separate legislation will refine the personnel systems of these agencies.

Bilateral Investment Agreements (BITs)
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¶40. Brazil has signed Bilateral Investment Agreements (BITs) with fourteen countries. There are two Mercosul investment-related agreements: the Buenos Aires Protocol ("extra-bloc") and the Colonia Protocol ("intra-bloc"); the latter has not been signed by Brazil. Seven of the bilateral investment treaties have been sent to the Brazilian Congress, but have not been ratified. All of these

treaties pending ratification were withdrawn from Senate consideration by the Executive in late 2003. The Executive cited the need for further review of the treaties so as to avoid potential juridical conflicts. At issue are the international arbitration clauses of these treaties, which may not be binding on Brazilian government agencies under Brazilian law. The US signed an Investment Warranty Treaty with Brazil in 1965 (OPIC). The US and Brazil currently have no plans to discuss a BIT.

OPIC and Other Investment Insurance Programs
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¶41. Programs of the Overseas Private Investment Corporation (OPIC) are fully available, and activity has increased in recent years. The size of OPIC's exposure in Brazil may occasionally limit its capacity for new coverage. For more information on OPIC, please go to http://www.opic.gov/.

¶42. Brazil became a member of the Multilateral Investment Guarantee Agency in 1992.

Capital Outflow Policy
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¶43. In 2005 the Central Bank introduced a new administrative regime for foreign currency transactions. The new regulations unified the foreign exchange market and removed many restrictions associated with remittances overseas, for example, removing a requirement for prior Central Bank approval for contracting loans in another country. The Central Bank maintained reporting requirements on all foreign exchange transactions. In a related effort, the Central Bank is working to streamline the regulatory regime for foreign investment transactions in Brazil.

¶44. There has been a relaxation since 1991 of the restrictions on the remittances of royalty payments for patent and trademark use between subsidiaries established in Brazil and the parent office headquartered overseas and on remittances of franchise contract royalties. A 1992 INPI resolution simplified procedures and, in particular, eliminated a number of requirements (but not all) concerning technology transfer agreements. No royalties or other fees may be transferred between related companies for the use of software.

Employer Federations Play a Significant Role
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¶45. Investors should be aware that employer federations, supported by mandatory fees based on payroll size, play a significant role in both public policy and labor relations. Each state has its own federation, which reports to CNI (National Confederation of



Industries), headquartered in Brasilia.

¶46. The Brazilian labor force comprises nearly 84 million workers in a wide range of occupations and industries. Nearly half of the labor force is employed in the service sector, roughly a quarter in agriculture, and the retail and manufacturing sectors combine to employ another quarter. The participation of women, who now account for over 40 percent of the labor force, continues to grow. The labor market has a high rate of informal sector employment; sources estimate that approximately 40 percent of all workers are not formally registered, pay no income taxes, and do not enjoy full protection under the law. About a quarter of all workers are self-employed.

¶47. Unemployment - significant. The Brazilian Institute of Geography and Statistics (IBGE) calculates an average unemployment rate for the country based on data collected monthly in Brazil's six largest metropolitan areas. According to this survey, the unemployment rate in November 2005 was 9.6%. This average masks some significant variation, from a high of 15.9% in Salvador to a low of 7.8% in Porto Alegre.

¶48. Real wages halt decline, disparities significant. Real wages in

2004 halted an almost decade-long slide and continued on an upward trend in 2005. Real wages were up 2.1% in November 2005 over November 2004. The average monthly wage in Brazil's six largest cities was approximately 974 Reals (approximately $423) in November 2005, and the minimum monthly wage was raised from 260 Reals in April 2004 to 300 Reals (approximately $130) in 2005. These averages gloss over some stark wage inequalities, as the wealthiest 50% of the Brazilian population earn nearly 90 percent of total income. Earnings also vary significantly by region and industry. The typical industrial worker in Sao Paulo, for example, earns about three times as much as the average retail worker in the northeastern state of Bahia.

¶49. Differences in earnings are caused in part by the regional disparity in educational attainment and in the availability of skilled workers. According to a 2002 survey by IBGE, 60 percent of the population has fewer than 8 years of schooling, with this number reaching 45 percent in the Southeast (including Rio and Sao Paulo) and 70 percent in the Northeast (including Recife and Salvador). Illiteracy rates also exhibit regional disparities. The IBGE reports that about 11 percent of the population is illiterate, with 7 percent illiteracy in the Southeast and 21 percent in the Northeast.

¶50. Unions play a significant role. Labor unions, especially in sectors such as metalworking and banking, tend to be well-organized and aggressive in defending wages and working conditions. In more remote areas with smaller local unions, however, unions tend to be less effective. Union members account for approximately 12 percent of the workforce, but unions represent more than twice this number in collective bargaining. Unions, which are funded largely by a mandatory tax equivalent to one day's wages per year, are obliged to represent all formal sector workers in a professional category and geographical area, regardless of membership status.

¶51. The Ministry of Labor estimates that there are over 16,000 labor unions in Brazil, but Ministry officials note that these figures are inexact. Local unions often associate with state federations and national confederations in their professional category. In addition, four major labor federations, known as "centrals," have emerged: the Workers' Unitary Central (CUT), the Union Force (Forca Sindical - FS), the Workers' General Confederation (CGT), and the Social Democratic Union (SDS). Labor unions channel much of the political activity of the labor movement. They also organize strikes and salary campaigns involving multiple professional categories and represent workers in many governmental and tripartite councils. While some labor organizations and their leadership operate independently of the government and of political parties, others are viewed as closely associated with political parties.

¶52. Extensive regulation, slow legal system. The labor code is highly detailed and relatively generous; formal sector workers are guaranteed 30 days of annual leave, an annual bonus equal to one month's salary, and severance pay in the case of dismissal without



cause. Brazil also has a system of labor courts that are charged with resolving routine cases involving unfair dismissal, working conditions, salary disputes, and other grievances. Currently, over 2.5 million cases languish in the labor court system, where they may remain unresolved for four or five years. The Brazilian government is attempting to reduce this backlog and increase the efficiency of the labor courts through recent initiatives to expedite legal procedures and increase the number of claims that are resolved before reaching the courts.

¶53. Labor courts have the power to impose an agreement on employers and unions if negotiations break down and either side appeals to the court system. As a result, labor courts routinely are called upon to determine wages and working conditions in industries across the country. The system is tantamount to compulsory arbitration and does not encourage collective bargaining. In recent years, however, both labor and management have become more flexible and collective bargaining has assumed greater relevance. The Inter-Union Department of Socioeconomic Studies and Statistics (DIEESE) no longer collects data on the number of strikes each month. Strikes

have been a frequent occurrence, however, particularly among public sector unions.

Major Foreign Investors
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¶54. According to the Central Bank's most recent foreign-capital census (December 2000), the US was the largest single foreign investor in Brazil followed by Netherlands, Spain, France, Germany and Portugal. Investment from the Cayman Islands began growing rapidly in 1995 and is thought to represent mainly repatriation of Brazilian capital entering the country as foreign investment and, to a lesser extent, investment activity by other national groups. Investment from Spain and Portugal surged beginning in 1998 due to involvement in telecom privatizations and greatly increased investment in the banking sector by Spain.

¶55. The stock of direct foreign investment in Brazil stood at $103 billion as of December 2000, the most recent year for which detailed data is available. Of this, the US had the largest share at about $24.5 billion (24%). Spain had 11.9% of the total ($12.2 billion) and The Netherlands 10.7% ($11.0 billion). Investment inflows since 2000 have amounted to about $87 billion, exclusive of depreciation and capital repatriation. (The Central Bank is expected to publish updated investment stock figures in 2006.)

¶56. Despite its leading position among foreign investors, as of 2005 the local operations of only two US companies - Cargill and AES - were among the top thirty domestic firms in terms of revenues. Four of the top ten importing firms in 2004 were foreign: Nokia, Motorola, Bunge, and Ford Motor Co. Six of the top ten exporters -- Bunge, Volkswagen, Cargill, General Motors, Ford and Halliburton -- represented foreign investment.

Efficient Capital Markets & Portfolio Investment
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¶57. Banking shakeout results in improved system. The Brazilian financial sector is large and sophisticated, in part a legacy of the high inflation period when good financial management was critical to survival. Despite current moderate inflation rates, bank-lending spreads remain extremely high due to taxation, repayment risk, lack of judicial enforcement of contracts, high mandatory reserve requirements and administrative overhead. Brazilian banks have weathered a difficult period of consolidation and streamlining over the last decade. The elimination of high inflation in the mid-1990s, and with it the disappearance of so-called "float income," led to liquidity problems among many banks. A series of failures, mergers, and acquisitions took place in the late 1990's. The surviving banks have returned to profitability. Today, the financial sector is fairly concentrated, with the 10 largest institutions accounting for over 65% of financial sector assets. Acquisitions have contributed to this trend as banks seek economies of scales, including through partnerships with retail chains. Lending by the large banking institutions is focused on the largest companies, leaving small and medium-sized companies underserved.



¶58. Most government-owned banks, in particular those that were owned by state governments, have been privatized. These insolvent institutions were taken over by the federal government, liquidated, privatized, or transformed into development agencies. Three federally owned banks, the largest in the country, still play a prominent role in the financial system. These federal banks, while in better shape than their state-level counterparts, were also undercapitalized and carrying poorly performing loans, many the result of the loss-making "social" lending. These banks have, to an extent, recapitalized by selling back government bonds. Extraordinary bank profits in 2002 - 2004 also have improved the health of their balance sheets. As part of an effort to prevent the need for future recapitalizations of these federal banks, the government now requires that loss-making social lending programs by any government-owned bank be supported with an explicit government subsidy.

¶59. Dealing with the bank failures and consolidations of the last several years has led the Central Bank to strengthen bank audits, implement more stringent internal control requirements, and tighten capital adequacy rules to better reflect risk. It also established loan classification and provisioning requirements. These measures are applied to private and publicly owned banks alike. The Central Bank intervened in medium-sized Banco Santos in late 2004 after embezzlement left the institution insolvent. Banco Santos was liquidated in 2005.

¶60. Stock markets not an option for most companies. Brazilian stock exchanges serve to raise financing primarily for domestic companies, although the Sao Paulo Stock Exchange (BOVESPA) aspires to a regional role. There were 9 Initial Public Offerings (IPOs) on the Sao Paulo Stock Exchange (BOVESPA) in 2005. In June 2004, Brazilian airline Gol executed an initial public share offering simultaneously on the Sao Paulo and New York stock exchanges. The total number of companies listed on the BOVESPA increased to 382 as of year-end 2005 from 361 in June 2004, compared to 399 in 2002 and 428 in 2001. Total turnover was about $430 billion in 2005, while total market capitalization was $482 million at end-2005. Trading is highly concentrated, with the top 10 stocks accounting for over 50 percent of turnover. Some 71 Brazilian firms, including Petrobras, Embraer, Banco Itau, CVRD, Brasil Telecom and Ambev, are also listed on the NYSE via American Depository Receipts (ADR's).

¶61. In 2000, with the intent of promoting the stock market and improving liquidity, the numerous regional stock markets agreed to consolidate. All stock trading is now done on the Sao Paulo stock market, while trading of public securities is conducted on the Rio de Janeiro market. The Sao Paulo stock market also launched a "New Market," in which the listed companies would comply with strict corporate governance requirements. As of 2005, the new market had 18 listed companies, down from 31 in June 2004.

¶62. Until recently, up to two-thirds of a corporation's capital could be preferred (non-voting) shares, so that it was possible to achieve majority control of voting shares, in some cases, by holding only 17 percent of total capital. In 2001, the Congress approved a law that limits preferred shares for new issuances to 50 percent. The same proposal strengthens rights for minority shareholders.

¶63. The Brazilian Securities Exchange Commission (CVM) directly regulates the stock exchanges, brokers, distributors, pension funds, mutual funds, and leasing companies. In 2001, new legislation granted the CVM independence and established stronger penalties against insider trading.

¶64. In January 2000, Brazilian regulators removed a number of remaining restrictions on foreign portfolio investment. As a result, foreign investors - both institutions and individuals - can directly invest in equities, securities and derivatives. The foreign investors are required to trade derivatives and stocks of publicly held companies on established markets. As of 2005, foreign investors accounted for 31.9% of the total turnover on the BOVESPA. Domestic institutional investors were the second most active category of market participants, accounting for 27.8% of BOVESPA transactions.

¶65. Export credit availability. BNDES, the government national



development bank, is the primary Brazilian source of longer-term credit, and also provides export credits. FINAME (Special Agency for Industrial Financing) provides foreign and domestic companies operating in Brazil financing for the manufacturing and marketing of capital goods. FINAMEX (Export Financing) is a part of FINAME, which finances capital good exports for both foreign and domestic companies. An export credit program for capital and some consumer durable goods, known as PROEX, was established in 1991. PROEX receives funds from the National Treasury to offer assistance in the areas of interest rate equalization, capital and other goods exports, and service exports.

¶66. Other issues: accounting and mergers. Wholly owned subsidiaries of multinational accounting firms, including the major

US firms, are present in Brazil. The failure of major banks and large businesses during 1995, notwithstanding positive financial statements prepared by the major accounting firms, raised doubts about the credibility of these financial statements. Beginning in 1996, auditors have been personally liable for the accuracy of accounting statements prepared for banks.

¶67. Brazilian law recognizes mergers, in which one company loses its separate identity by being merged into another, and consolidations, in which the pre-existing companies are extinguished and a new entity emerges. The procedures for both are essentially the same. Sales of Brazilian companies usually result from private negotiations, rather than stock exchange activities. Acquisitions resulting in market concentration in excess of 20 percent are subject to review by the Administrative Council for Economic Defense (CADE) under Brazil's 1994 Anti-trust Law.

CHICOLA